No. 9824.

IN THE

United States Circuit Court of Appeals

FOR THE NINTH CIRCUIT

Artesian Water Company, a corporation,

Petitioner,

vs.

Commissioner of Internal Revenue,

Respondent.

BRIEF FOR APPELLANT.

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TOPICAL INDEX.

June 11, 1940. On January 22, 1941, the Board handed down its findings of fact and opinion and entered its final order in the appeal [Tr. pp. 21-37].

On April 16, 1940, the petitioner filed its petition for review by the United States Circuit Court of Appeals (Ninth Circuit) [Tr. p. 38], and duly completed the filing of said petition by service of a copy thereof and a praecipe upon counsel for the respondent [Tr. p. 132], proof of which service is on file with the clerk of this Honorable Court.

Statement of the Case.

The only question in this case is whether the petitioner should be subjected to the undistributed profits tax (Revenue Act of 1936, Section 14) for not having distributed its income to its stockholders in the calendar year 1937.

Briefly stated, the facts are:

The petitioner, a California corporation, was an owner of lands. In 1929 it gave its note for $175,000.00 to the Pacific Mutual Life Insurance Company to cover indebtedness owed to that company. It secured this note by a mortgage on all its income-producing assets [Tr. p. 77] and, as additional security, petitioner assigned to the insurance company its lease with Shell Oil Company and all the income therefrom [Tr. p. 24]. The latter income from oil constituted over 90 per cent of petitioner's total income [Tr. p. 24]. In 1931 petitioner gave the insurance company an additional note for $35,000.00, which note was not subjected to the prior mortgage and assignment, but, with respect to this note, the petitioner agreed not to declare dividends until it was paid.

Both of these notes matured on November 12, 1934. Nothing was paid on the principal of either note at maturity. Petitioner requested extension of time, but was refused [Tr. p. 84].

In 1935 the petitioner was placed in involuntary receivership, not by its own creditors but by a creditor of one of its stockholders. The receivership continued until 1939, when petitioner was discharged.

As soon as appointed the receiver started negotiations with the insurance company for an extension of time within which to pay the two notes above mentioned. After several refusals, the receiver was finally given an informal extension to March 3, 1937, provided certain payments were made each month in the interim. The receiver was notified in writing at this time, however, that no extension would be granted beyond March 2, 1941, and that the insurance company would expect payment to be made in full not later than that date. The receiver made strenuous and determined efforts to refinance the notes. He negotiated with many banks and brokers, but without success.

Unable to refinance, the receiver paid such amounts as he could. In 1936 he paid $26,750.00, all of which was applied on the second note. In 1937 the receiver paid a total of $83,000.00, $8,250.00 of which paid the balance owing on the second note, and the remainder, or $74,-750.00, was applied on the first note. Every payment was made pursuant to the instruction and order of the Superior Court. In the taxable year 1937 petitioner paid its entire net income on the notes, plus approximately $30,000.00 out of its depletion reserves. At the close

of the taxable year petitioner still owed a balance of $100,250.00, which, at the time, it was wholly unable to pay.

The petitioner filed its income tax return for 1937 and paid a normal income tax of $6,955.17. The Commissioner found the income stated in the return correct and the normal tax paid correct, but imposed on the petitioner a surtax of $7,380.33 for not having distributed its income to its stockholders. In asserting such surtax, under Section 14 of the Revenue Act of 1936, Commissioner allowed as a credit the $8,250.00 paid in 1937 on the second note, but refused to allow any credit for amounts paid on the first note.

Assignment of Errors.

(1) The Board erred in holding that the petitioner was subject to surtax under Section 14 of the Revenue Act of 1936 for not distributing its profits to its stockholders in the year 1937.

(2) The Board erred in not finding as a fact, and holding as a matter of law, that the petitioner was in receivership and insolvent during 1937, or a portion thereof, and, therefore, under the provisions of Section 14(d)(2) of the Revenue Oct of 1936, not subject to surtax imposed by Section 14(b) of that Act.

(3) The Board erred in not finding as a fact, and holding as a matter of law, that the mortgages of petitioner's income producing assets and the assignment of its leases and income, under the circumstances and commitments existing in the taxable year, did constitute a contract restricting it from the payment of dividends within the meaning of Section 26(c)(1) of the Revenue Act of 1936.

(4) The Board erred in not finding as a fact, and holding as a matter of law, that the mortgages of petitioner's income producing assets and assignment of petitioner's leases and income, under the circumstances and commitments existing in the taxable year, did constitute a requirement that the petitioner pay on, or set aside for payment on, its indebtedness, its earnings and profits of the taxable year and, therefore, render it exempt from surtax under the specific provisions of Section 14 (c) (2) of the Revenue Act of 1936 to the extent such earnings were so applied.

Summary of Argument.

The petitioner was in receivership and insolvent in the year 1937 and therefore, under Section 14(d)(2), not subject to undistributed profits tax. By the word "insolvent", Congress meant "unable to pay the claims of creditors as they mature."

Long prior to the taxable year the petitioner had assigned its oil lease and all income therefrom to its creditor, the Pacific Mutual Life Insurance Company. Such assignment under California laws, which is controlling, passes full title in such income to the creditor. Income so assigned was no longer available to the petitioner for the declaration of dividends. Such assignment constitutes a contract, expressly restricting the payment of dividends and expressly making disposition of the earnings and profits within the meaning of Section 26(c)(1) and (2) of the Revenue Act of 1936. As petitioner's entire income was applied in partial payment of its debt, it is entitled to credit against undistributed profits tax for the entire amount of the same under Section 26(c)(1) and (2).

ARGUMENT.

I.

The Petitioner Was in Receivership and Insolvent in the Taxable Year.

Section 14(d)(2) of the Revenue Act of 1936 provides as follows:

> "(d) Exemption from surtax.—The following corporations shall not be subject to the surtax imposed by this section:
>
> * * * * * * * *
>
> "(2) Domestic corporations which for any portion of the taxable year are in bankruptcy under the laws of the United States, or are insolvent and in receivership in any court of the United States or of any State, Territory, or the District of Columbia.
>
> * * * * * * * *"

There is no question about the receivership, so we pass to the question of insolvency.

The word "insolvent" is a flexible term that has been given various meanings, sometimes by statute, and often by the courts in varying situations. I have no doubt if the word "insolvent" had merely been inserted in Section 14(d)(2) and no definition left by Congress, that the courts, with an eye to the essential nature of the undistributed profits tax and its potential harshness in operation, would have given the term its most liberal meaning. But conscious perhaps of the several meanings attached to the word "insolvent", the Senate Finance Committee, who inserted the word into the Act, also defined the meaning it was to carry. The following is an extract from the report of the Senate Finance Committee on the Revenue Bill of 1936, found on page 15 of that report, dated

June 1, 1936. In discussing Section 14(d)(2), the chairman said:

> "Section 105 of the House Bill exempted domestic corporations in bankruptcy or receivership from the undistributed-profits tax in that bill and subjected them to a flat 15 per cent rate of tax. The bill as reported (section 14(c)(2)) similarly exempts such corporations from the 7 per cent undistributed-profits surtax and applies to them the graduated rates applicable to other corporations. The committee proposal specifically exempts the corporation in this situation from the undistributed-profit surtax for its entire taxable year even if it is bankrupt or in receivership for only a part of the taxable year. This proposal is founded on the principle that if a corporation goes into bankruptcy or receivership after its taxable year has started, it is so weak that an undistributed-profits surtax ought not to be or can not be imposed upon it. Similarly, if it comes out of bankruptcy or receivership during its taxable year, it should be allowed to operate free of such tax during the remainder of the year in order to recover its strength. The Finance Committee bill also avoids the possibility of tax avoidance by collusive receiverships by limiting the provision to cases in which the corporation is in bankruptcy under the Federal bankruptcy laws, and to cases in which it is insolvent—i. e., its liabilities are in excess of its assets or it is unable to pay the claims of creditors as they mature—and in receivership in Federal or State courts."

The report, we believe, evidences three things:

(1) That the word "insolvent" was added to prevent collusive receiverships instigated to evade tax. There is no question of collusion here because the receivership was

instituted in 1935, before an undistributed profits tax was even discussed.

(2) That Congress recognized the potential harshness of the tax and sought to safeguard a company in a weakened financial condition against its operation.

(3) That the word "insolvent" means a taxpayer unable to pay its debts as they mature.

The Government argued below that the statute intends that the receivership shall be instituted *on the ground of* insolvency. If the Board did not actually acquiesce in this position, it, at least, emphasized it greatly in its opinion. We find no such requirement in the statute. The statute merely requires that the two conditions be concurrent, that is, that the taxpayer be *in receivership* and *insolvent* at the same time and at sometime during the taxable year. A taxpayer who is laboring under those two conditions is in just as bad a position, regardless of how he was placed into receivership. All of the reasoning that urges the relief from the tax in the case of one, urges it in the case of the other. We see no ground for the distinction either in the wording of the statute, or outside the statute.

The evidence in this case shows beyond any reasonable doubt that this petitioner was unable to pay its matured and past due debts in the year 1937. It is the petitioner's contention that when this is shown, it matters not if its assets under normal conditions were in excess of its liabilities (see cases cited below on this point), and it matters not if its inability to pay its debts was due in part, or in whole, to the fact that it was in receivership. The solvency or insolvency of the petitioner, that is, its ability to pay its debts, must be determined in the actual situation in which the petition is found in the taxable year and

not in some false and assumed situation in which it is not found, for example, free from receivership.

Passing to a review of the evidence and findings, we find the following:

(1) Immediately upon his appointment, the receiver began negotiations to obtain an extension of the loans. [Board's Findings of Fact, Tr. p. 26.]

(2) The conservator appointed for the Pacific Mutual Life Insurance Company in 1936 disapproved the loans and refused any extension of time. [Board's Findings of Fact, Tr. p. 27.]

(3) The receiver then attempted to refinance the loans but was unsuccessful. [Board's Findings of Fact, Tr. p. 26.]

(4) In his efforts to refinance the loans the receiver negotiated with the loaning officers of the California Bank, Security-First National Trust & Savings Bank, and two or three other banks in town, with the idea of attempting to procure a new loan. All of the negotiations fell through, due to the fact that none of the loaning officers felt they could make a new loan signed by the receiver. The title companies would not issue satisfactory title. [Rec's Test, Tr. p. 97.] The negotiations failed, also, because the value of the properties was more or less unknown. The Security Bank spent considerable time in appraising the properties but declined the loan. [Rec's Test, Tr. p. 98.] The receiver's efforts to refinance were also hampered and embarrassed because of the fact that the notes were already two years in default. That objection was brought up continually. [Rec's Test, Tr. p. 104.]

The receiver's testimony and the Board's findings show without any doubt that in 1937 this petitioner was in a

Russell etc. Co. v. E. C. Faitonta Hdw. Co. (N. J. Ch.), 62 Atl. 421;

Baker v. Emerson, 4 App. Div. 348, 38 N. Y. 5576;

Thompson v. Thompson, 4 Cush. (Mass.) 127, 134.

Section 3450, Civil Code of California:

"A debtor is insolvent, within the meaning of this title, when he is unable to pay his debts from his own means as they become due."

Sam Ramazzina et al., Co-partners Under the Firm Name and Style of Ramazzina Brothers, an Insolvent Debtor, 110 Cal. 488:

"* * *

"It is also insisted that the co-partnership of Ramazzina Brothers was not insolvent at the time of the filing of said petition, as shown by a comparison of its assets and liabilities appearing therein. While it does appear therefrom that the valuation of the partnership assets exceeds considerably the liabilities of the partnership, yet the petition further discloses that the partners individually are hopelessly insolvent. The petitioners further allege directly that they are insolvent, and the mere fact that the assets in value exceed their liabilities does not prove solvency. Such fact might exist, and often does exist, and still a debtor be entirely insolvent within the purview of the Insolvent Act. * * *."

First National Bank of Silverton v. E. J. Walton, 5 L. R. A. 765, Colorado Supreme Court:

"By insolvency is meant an inability to fulfill one's obligations according to his undertaking, and general

> inability to answer in court for all of one's liabilities existing and capable of being enforced; not an absolute inability to pay at some future time, upon a settlement and ending up of a trade, but as not being in condition to pay one's debts in the ordinary course, as persons carrying on trade usually do."

Alpha Hardware & Supply Co. v. Ruby Mines Co., Cal. App. 97, Whiting 1929, p. 515:

> "(7) A debtor is insolvent when he is unable to pay his debts from his own means as they become due. *Southwick v. Moore,* 61 Cal. App. 585 (215 Pac. 704); *First National Bank of Los Angeles v. Maxwell,* 123 Cal. 360 (69 Am. St. Rep. 64, 55 Pac. 980)."

32 *Corpus Juris* 806, states that the word "insolvency" has two meanings:

> "In its general and popular meaning the term denotes the state of one whose entire property and assets, when converted into money without unreasonable haste or sacrifice, are insufficient to pay his debts; * * * But it is frequently used in the more restricted sense to express the inability of a person to pay his debts as they become due in the ordinary course of business."

This petitioner in 1937 was not only unable to pay its debts in the ordinary course of business, but was unable to pay them by hypothecating and pledging all of its assets and income. Congress certainly intended to afford relief to a taxpayer so placed when it said "in receivership and insolvent" and then defined "insolvent" to mean "unable to pay claims of creditors as they mature." With such language in the act, Congress should

not be held to have intended to impose a surtax on a company situated as was this petitioner for *not* doing what, in the first place, *it couldn't do* and what, in the second place, *it sholdn't do,* that is, distribute its income to its own stockholders. I say "couldn't do" because it was entirely under the jurisdiction of the Superior Court and payment of its entire income to its creditors was made on instruction and order of the Court. I say "couldn't do" also because no court in California would permit distribution of profits to stockholders under such circumstances. The California codes, in fact, prohibit and make quasi-criminal declaration of dividends under such circumstances. In addition, the entire income had been assigned to the creditor and belonged to the creditor, as will be shown later in this brief. I say "shouldn't do" from every standpoint, moral, legal, equitable and financial, for reasons that are obvious. The company did the only thing it could and should do—it paid its entire net income to its creditor. After doing so, it still had an indebtedness of $100,250.00, which it had no means within its power at that time to liquidate.

The statute we are here discussing has been repealed. It was too harsh, even in a day of unparalleled harshness in revenue laws. Effect must be given to the words of the statute for the short period in which it still remains effective. But the statute should not be extended beyond its necessary implications. We feel that is what the Board of Tax Appeals has done in this case. Congress never intended to penalize a company in the

position of this petitioner in the year 1937 for not distributing its net income to its own stockholders, and there is ample basis in the language of the act itself to sustain that statement. A number of cases defining insolvency and applying a definition to varying situations have been shown above, but no better definition can be found than the one the Finance Committee itself gave. It is in full accord with the definition long ago given by the Supreme Court of the United States in *Cunningham v. Norton,* 125 U. S. 77, wherein Mr. Justice Bradley said:

> "Secondly: It is objected that the deed of assignment does not, on its face, show that the assignor was insolvent, or in contemplation of insolvency. The obvious answer is that if this is a necessary requirement, the deed does state that the assignor 'is indebted to divers persons in considerable sums of money, which he is at present unable to pay in full.' When a person is unable to pay his debts, he is understood to be insolvent. It is difficult to give a more accurate definition of insolvency. The objection is without foundation."

The Board apparently based its holding against petitioner as to insolvency on three grounds, viz:

1. The receivership was not instituted on the ground of insolvency [Tr. pp. 31 and 33].

2. Book value of assets greatly exceeded liabilities [Tr. p. 33].

3. Petitioner had a net income of $54,101.14 for 1937.

We have already mentioned our reasons for believing the statute does not require the first. If the definition of insolvency given by the Senate Finance Committee be accepted, the second ground is immaterial. The authorities and cases cited so hold, even when *actual* value of assets be considered. But here the Board is considering mere book values, which in this instance are write-up values as of March 1, 1913 [Tr. p. 100]. Values were lower in 1937 than in 1913 [Tr. pp. 100, 101]. No oil depletion had ever been charged against assets on the books [Tr. pp. 94, 95]. The *book* values on which the Board relied are generally discredited by receiver's efforts to raise money without success, and specifically so by the fact that the Security Bank spent considerable time in appraising the assets of the company and then declined to make a loan [Tr. p. 98].

As to the third ground, the statute requires only that at some portion of the taxable year the taxpayer be in receivership and insolvent. Looking at the picture at the beginning of the year, as we are entitled to do, we have a balance owing of $185,000.00 and already an operating deficit of $50,571.97, which deficit would be greatly increased if depletion were charged to surplus, as it should be. Judging by the amounts the receiver, under pressure, had been able to pay to the insurance company during 1935 and 1936, viz., nothing in 1935 and $26,750.00 in 1936, the prospects of petitioner paying its debts then or by March 2, 1937, or at any time in the immediate future, were nil. When to this picture is added the fruitless efforts of the receiver to raise money with which to pay debts, the insolvency of the petitioner, within the meaning intended by Congress, is well established.

II.

The Petitioner's Promissory Note, Combined With the Assignment of Its Lease and the Income Therefrom, Constituted a Contract Restricting Payment of Dividends and Disposing of the Earnings of the Taxable Year Within the Meaning of Section 26 (c) (1) and (2) of the Revenue Act of 1936.

The pertinent portion of Sections 26(c)(1) and 26(c)(2) are set out below:

"SEC. 26. CREDITS OF CORPORATIONS.

"In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

* * * * * * * * *

"(c) * * *

"(1) * * *. An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends.

* * * * * * * * *

"(2) * * *. An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside."

> a chattel mortgage, which conveys the thing mortgaged, with power to collect, hires and to use the chattel until the money secured thereby is paid; and, until payment is proved, all the right of the mortgagor to the mortgaged property passes to the mortgagee."

Change of possession is not essential to validity:

3 *Cal. Jur.*, p. 204:

> Things in action expressly exempted under the code from statutory rule requiring a valid transfer of personal property to be followed by immediate delivery and change of possession, in order to make transfer valid (Civil Code Cal., Sec. 3440). So where an assignment is absolute in its terms and conveys a personal interest in the written evidence of the chose in action, it is complete, and TITLE THERETO IS VESTED in assignee notwithstanding that possession and control of the chose in action are retained by the assignor.

If the assignee becomes the owner of income so assigned, as the above cases and authorities demonstrate, by what theory can the assignee declare a dividend out of such income? It is true for the purpose of normal income tax the income is still technically the income of the assignor and properly taxable to the assignor, because though he should never possess the income, it is being applied for his benefit. But to impose a surtax because the assignor does not declare a dividend out of such assigned income, which is no longer his, is quite a different matter and one that obviously should not be indulged in if any reasonable interpretation of the law permits other treatment.

Discussing Section 26 (c) (1) first, the Board in its Opinion said [Tr. p. 35]:

> "There is nothing to show that the assignment of the Shell Co. oil royalties by petitioner to its creditor, the Pacific Mutual Insurance Co., as further security for the payment of its $175.000 note, in any manner expressly restricted petitioner in the payment of dividends. This assignment is not in evidence and we do not know what written provisions it contained, but the witness who testified in regard to it did not say that the assignment dealt 'expressly with the payment of dividends.' Petitioner does not so contend in its brief. It simply contends that because petitioner had assigned these oil royalties to its creditor, as additional security for the payment of its notes, it was by necessary implication prohibited from the payment of any dividends during the effective period of the assignment."

The Board decided this case soon after the Supreme Court handed down its opinion in *Helvering v. Northwest Steel Rolling Mills, Inc.*, 311 U. S. 46. The Board was doubtless influenced and guided, as it should be, by that decision. But we do not understand the Court's language in that case to go so far as to hold that a specific contract expressly assigning title to income out of which dividends might be declared was not a contract dealing expressly with the declaration of a dividend. In the *Northwest Steel Rolling Mills, Inc.,* case the Supreme Court was dealing with statutorily prohibited dividends and it said:

> "The natural impression conveyed by the words 'written contract executed by the corporation' is that an explicit understanding has been reached, reduced to writing, signed and delivered."

(3) The amount of earnings sought as a credit was "required . . . to be irrevocably set aside within the taxable year for the discharge of a debt. The assignment of the earnings constituted an irrevocable setting aside and for no purpose other than "for the discharge of a debt."

(4) ". . . to the extent that such amount has been so paid or set aside." The entire royalty earnings were both set aside and paid on the debt within the taxable year.

The note and assignment covered only the oil lease income but this was over 90% of total income. In this regard the statute (Sec. 26 (c) (2)) provides:

> "For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits."

The fact that the creditor became the actual owner of the earnings by assignment differentiates this case from nearly every decision rendered thus far under Section 26 (c), including those cases decided by the Supreme Court. The *G. B. R. Oil Corporation,* 40 B. T. A. 738, was another case where earnings *were assigned* and the Board in that case upheld the taxpayer. In the *G. B. R.* case the creditor, a bank, did receive the income in the first instance but examination of the case (40 B. T. A. 737 at p. 739) shows that the bank immediately deposited its receipts in the deposit account of the debtor and later

the debtor, after paying expenses, gave the bank a check on the deposit account for an amount to be applied on the debt. In the instant case the creditor permitted the petitioner to collect. The creditor could have required payment to itself direct at any time [Tr. p. 86]. There is no difference in the contracts. The creditor had the same rights under both and actual payment was made under both.

Respectfully submitted,

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